REPORT No. 5

The Pension Benefits Act, 1987: Implications for the public sector pensions consultations

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David W. Conklin, 1988

Public Sector Pensions Consultations

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Ontario Public Sector Pensions Consultations

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Public Sector Pensions Consultations

THE PENSION BENEFITS ACT, 1987: IMPLICATIONS FOR THE PUBLIC SECTOR PENSIONS CONSULTATIONS*

July 18, 1988

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Part 1: Overview

The Pension Benefits Act, 1987 and its regulations include many new reform provisions. Some of these, like the joint and survivor requirement, do not necessarily involve an increase in costs; others involve additional costs that can be calculated with actuarial methodology that is generally accepted. The following analysis focuses on those provisions where the need for decisions based upon interpretation and judgement will require discussion and negotiation between the Ontario government and representatives of the public service and teachers. The analysis deals with post-reform benefits. With a few exceptions, the Act and its regulations are not retroactive. For the public service and teachers, retroactivity will be a major subject, and the Pension Benefits Act provides few requirements. Hence it is likely that considerable discussion and negotiation will focus on various aspects of retroactivity and the treatment of benefit, surplus, and

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* Responsibility for the interpretations and opinions are those of the author and should not be attributed to the Public Sector Pensions Consultations or any other group or person. Nevertheless, the author wishes to thank the staff of the Pension Commission of Ontario for their assistance and for their contributions to the analyses contained in this paper.

Public Sector Pensions Consultations

THE PENSION BENEFITS ACT, 1987: IMPLICATIONS FOR THE PUBLIC SECTOR [illegible]

July 15, 1988

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Part 1: Overview

The Pension Benefits Act, 1987 and its regulations include many new reform provisions. Some of these, like the joint and survivor requirement, do not necessarily involve an increase in costs; others involve additional costs that can be calculated with actuarial methodology that is generally accepted. The following analysis focuses on those provisions where the need for decisions based upon interpretation and judgement will require discussion and negotiations between the Ontario government and representatives of the public service and teachers. The analysis deals with post-reform benefits. With a few exceptions, the Act and its regulations are not retroactive. For the public service and teachers, retroactivity will be a major subject, and the Pension Benefits Act provides few guidelines. Hence it is likely that considerable discussion and negotiation will focus on various aspects of retroactivity and the treatment of benefit, margins, and

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unfunded liabilities that accrued prior to 1/1/1988. These retroactivity issues are not dealt with here.

The Pension Benefits Act, 1987, together with its regulations, may impact public sector pensions in ways not clearly described by the Rowan and Coward Task Force Reports. The Pension Benefits Act also deserves special attention because of Mr. Coward's emphasis that public sector employees should be treated in the same way as private sector employees. Among the four principles which guided Mr. Coward was the following:

> (1) Public sector employees should not be financially advantaged or disadvantaged relative to private sector employees by their participation in pension plans sponsored by Ontario (Introduction, p.1).

Part 2 of this paper focuses on Section 40 of the Act and Section 21 of the Regulations, indicating the need to consider these sections in the reform of public sector pension plans. Section 40 of the Act requires that each employee's contributions plus interest shall not exceed 50% of the commuted value of that employee's pension. Any amount by which the employee's contributions plus interest do exceed 50% of the commuted value of the employee's pension shall be refunded to that employee. The relevant calculations shall be performed at the time of termination of membership or employment. Consequently, every member will potentially come under the 50% rule of Subsection 40(3) at some point in their career. This pension reform may increase the entitlement of some public sector employees, and may increase the financial obligation of the Ontario government.

Section 40 of the Act and Section 21 of the Regulations may affect certain aspects of Laurence Coward's solution. Recommendation (22) of Mr. Coward's summary is a key recommendation which may be affected:

> (22) After the members' contribution rate has been realistically established, the employer should pay the balance of cost as determined by actuarial valuations, being obliged to amortize any deficit and being entitled to benefit from any surplus (p. 9).

At the present time, the teachers' and public service pension plans have been granted exemptions from certain sections of the Act and Regulations. Implementation of the Rowan and Coward recommendations could entail the repeal of these exemptions. Part 3 of this paper considers Section 43 of the Regulations which presents these exemptions. With the shift of pension fund investments to market securities, it may no longer be appropriate to exempt these plans from Subsection 23(1) and Section 63 of the Act. Consequently, Part 3 discusses the impact on these plans of such a repeal of exemptions.

Part 4 discusses the provisions in the Act that deal with the funding of escalated adjustments, the procedures for plan wind-ups, and the treatment of surplus. These issues are important in Mr. Coward's recommendations, and so Part 4 considers the relationships between these recommendations and the existing provisions of the Act.

Part 2: <u>Section 40 of the Act and Section 21 of the Regulations: The 50% Rule</u>

Section 40 is concerned with employee contributions towards the commuted value of a pension or deferred pension in cases where the employee terminates employment. Section 40 stipulates certain relationships between past employee contributions, on the one hand, and the commuted values of the benefits related to these contributions, thereby placing a limit on the amount that the employee has to pay for these benefits.

Subsection 40(1) deals with that portion of a pension that has accrued in respect of employment before 1/1/1987. The commuted value must be at least as great as the employee's contributions, plus interest credited to those contributions. If the commuted value is less than this amount, then it must be increased to this amount.

Subsection 40(2) provides that the calculation of the commuted value may include any increases in benefits that have resulted from plan amendments after 1/1/1987. That is, in satisfying the requirement that the commuted value must equal or exceed the employee's contributions plus interest, the plan administrator may include not only the original promised benefits but also any later increases in these benefits. For plans where benefits have been enriched, Subsection 40(2) reduces the impact of Subsection 40(1) by making it less likely that the commuted value must be increased.

With Subsection 40(3), the Act provides a significant advantage for employee contributions made after 1/1/1987. Whereas Subsection 40(1) provides that contributions prior to 1/1/1987 plus interest credited to them will not exceed the commuted value of the pension, Subsection 40(3) provides that contributions after 1/1/1987 plus interest credited to them will not exceed 50% of the commuted value of the pension. The purpose of Subsection 40(3) is that each employee's contributions plus interest shall not exceed 50% of the commuted value of that employee's pension. Any amount by which the employee's contributions do exceed 50% of the commuted value of that employee's pension shall be refunded to that employee. The relevant calculations shall be performed at the time of termination of membership or employment. It is important to note that retirement is a termination of employment. Consequently, every member will potentially come under the 50% rule of Subsection 40(3) at some point in their career. This pension reform may increase the entitlement of some employees, and may increase the financial obligation of the Ontario government. The following example illustrates the operation of the 50% rule, which relates to contributions and benefits accrued after January 1, 1987.

The financial impact of this reform will vary depending upon the plan's provisions and also depending upon the age of the employee at termination of membership or employment. For most plans, the value of pension benefit accruals increases sharply with age, particularly if high inflation rates are assumed; and the percentage of a member's benefit

Numerical Example - 50% Rule

An individual is 35 years old, has worked for the same employer 5 years (contributions are not vested prior to January 1, 1987; but contributions after January 1, 1987 are vested), and terminates his employment on September 1, 1987.

Present value of future pension as of September 1, 1987	= $ 1,000
September value of Employee Contributions (including interest) to Pension Plan	
Prior to December 31, 1986	= $ 800
Prior to September 1, 1987	= $ 950
Between January 1, 1987 and September 1, 1987	= $ 150
Commuted Value of Benefits earned between January 1, 1987 and September 1, 1987	= $ 200

Employee Benefits

(A) Upon Termination

(1) $800 non-vested employee contribution (including interest) to Pension Plan

(2) $50 refund of contribution to the plan for more than 50% of the vested benefits earned after January 1, 1987, i.e.: paid in $150, benefits earned during that time $200; therefore refund is $50 ($150 - [$200 x 50%]).

(B) Upon Retirement

(1) Pension from the vested benefits earned between January 1, 1987 and September 1, 1987. The September 1, 1987, commuted value of these is $200.

purchased by the member's own contributions decreases sharply with age. A research report by Professor James Pesando illustrates this point. For a representative plan and 10% inflation, Pesando has indicated in Table 1* that the commuted value of the benefit earned while the employee is 45 years of age is only 1% of income. It is only while the employee is 56 or 57 years of age that the commuted value of the benefit earned reaches 5%-6% of the employee's income. While the employee is 62 or 63 years of age, the commuted value of the benefit earned may reach 18%-20% of the employee's income.

In such a plan, if the employee terminates employment at an early age, the refund of excess contributions may be substantial, even if the employee retains plan membership and the right to the deferred pension. Hence, early terminations may impact the plan's funding.

For an employee hired at a late age, the employer may ultimately have to pay more than 50% of the cost of the benefit even though the annual contributions are equal for the employee and the employer. Hence, to the degree that an employer hires older employees, the employer cost of an equal contribution plan will exceed 50%, and supplementary payments will have to be made from time to time. From the employee's perspective, switching from one employer to another in mid-career may provide an

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* See James Pesando, "Assessment of Alternative Formulas for Delivering Inflation Protection," Task Force on Inflation Protection for Employment Pension Plans. Volume 1. pp. 181-187.

aggregate benefit more than twice the value of the employee's aggregate contributions plus interest, even if both plans require annual contributions that are equal for the employee and employer. Prior to the 1987 Pension Reform Act, an employer could offset some or all of these higher costs through the gain the fund receiver when an employee terminated before retirement. The new Section 40 requirements limit the gains that the fund receives from early terminations. This perspective suggests that the impact of Section 40 may occur not only on terminations of young employees, but also on hirings of older employees. It suggests the significance of pension costs in the hiring decision.

It should be noted that Section 58 of the Regulations provides that "Subsection 40(3) of the Act does not apply to the transfer of money or credits from one pension plan to another plan in accordance with a reciprocal transfer agreement." By entering reciprocal transfer agreements with other plans, an employer may reduce its exposure to paying for more than 50% of the benefits as a result of terminations of younger employees and hirings of older employees.

Section 21 of the Regulations prescribes the methods that may be used to calculate the interest to be applied to employee contributions. A defined benefit plan can provide for the use of either (a) the CANSIM series B rates for five-year personal fixed term chartered bank deposit rates; or (b) such rate of return as can reasonably be attributed to the pension fund or that part of the fund to which the contributions are made. For public sector pensions, the current plans do not provide for

either (a) or (b) but staff have simply chosen to use (a) without explicit legal authorization in the plan documents. This choice is extremely important, and it impacts strongly on the issue of surplus. If (b) were chosen, then approximately 50% of any pre-termination surplus attributed to an actuarial underestimate of the fund rate of return would automatically go to the employee. The significance of Section 40 of the Act and Section 21 of the Regulations will be affected by the rate of inflation and the degree to which actuarial projections accurately estimate the actual rates of return.

In regard to these implications, it appears that Section 40 of the Act and Section 21 of the Regulations affect certain aspects of Laurence Coward's solution. Recommendation (22) of Mr. Coward's summary is a key recommendation which may be affected:

> (22) After the members' contribution rate has been realistically established, the employer should pay the balance of cost as determined by actuarial valuations, being obliged to amortize any deficit and being entitled to benefit from any surplus (p. 9).

Consequently, it will be important to consider the impact of Section 40 of the Act and Section 21 of the Regulations on pre-termination surplus when evaluating the advisability of adopting Mr. Coward's solution. It is important also to consider the issue of post-termination surplus. Under the Act, Mr. Coward's solution, and in particular, recommendation (22) cited above, could be imposed for post-termination funding. However, there are two conceptual problems with this approach,

quite apart from employer-employee negotiation conflicts. These deserve comment.

First, the benefit is being promised on the basis of only one organization's calculations and projections. A competitive bidding might offer the employee a better deal. Within the context of a guaranteed benefit where the guarantor pays any deficit and retains any surplus, the employee might receive a more lucrative proposal from a life insurance company. That is, once the commuted value of the benefit has been calculated on termination, a life insurance company might offer a higher fully indexed annuity than that based on the government's benefit formula. It could be argued that the employee or representative should be given the opportunity to survey the market.

Second, the employee may prefer a benefit that entails some risk and uncertainty, but which may offer the possibility of a higher annual payment. It could be argued that the employee or representative should be given this choice. Here one can see the usefulness of an "excess interest" approach, and the inappropriateness of much established criticism of the excess interest approach.

Generally, critics have dismissed the excess interest approach because returns will not follow the rate of inflation closely. Mr. Coward has repeated this argument, and has noted that "[t]he only way to produce pension increases approximately equal to the inflation rate is to invest the fund in Treasury bills or short-term bonds; such investments

tend to reduce the return on the fund".

The key point, however, is that excess interest offers the employee the option of a higher return with higher risk and uncertainty than does the guaranteed annuity, fully indexed. The employee wanting an excess interest approach may consciously prefer a return that obviously cannot track inflation closely, since the return is based on the return to equities and/or bonds. The Treasury bill solution is irrelevant from this perspective.

One can see the excess interest approach as a constrained defined contribution approach. In return for the defined contribution of the commuted value of the government's promised benefit, the employee will receive a benefit that will vary with the overall fund performance (or the performance of an external benchmark portfolio), with the constraint that a certain base rate is guaranteed. A fund return that exceeds the government's actuarial projections and that would result in a surplus under Mr. Coward's solution would under an excess interest approach belong to the employee. The degree of risk and uncertainty for the employee would depend upon the guaranteed base rate, as would the risk that the government would have to contribute towards possible future deficits. The possibility exists, of course, that the private sector might offer such an excess interest approach in response to employee preferences, quite apart from a decision for the government to offer such an option.

Part 3: Exemptions Provided by Section 43 of the Regulations

At the present time, the public sector pension plans have been granted exemptions from certain sections of the Act and Regulations. Implementation of the Rowan and Coward recommendations could entail the repeal of these exemptions. Part 3 of this paper considers Section 43 of the Regulations which presents these exemptions. With the shift of pension fund investments to market securities, it may no longer be appropriate to exempt the public sector plans from Subsection 23(1) and Section 63 of the Act. Consequently, Part 3 discusses the impact on the public sector plans of such a repeal of exemptions.

Subsection 23(1) requires that the plan administrator exercise the care, diligence, and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person. Section 63 requires that the selection of investments be in accordance with the criteria set out in the Act and prescribed by the Regulations. These exemptions under Subsection 43(3) have meant that the government of Ontario and its representatives have not been subject to the administration and investment rules and criteria that are required of other employers. Rather the government of Ontario and its representatives have had considerably more latitude in these areas of responsibility. This latitude may no longer be necessary or appropriate, if the Rowan and Coward recommendations are implemented.

Section 23 places legal responsibility for the administration of the plan and investment of the pension fund on each plan administrator. Subsection 23(1) requires that the administrator act as would a "person of ordinary prudence....in dealing with the property of another person."This subsection covers all decisions of the administrator. Subsection 23(2) clarifies this responsibility by requiring that the administrator must use all his or her "relevant knowledge and skill" in these decisions. Furthermore, the administrator must use all the relevant knowledge and skill that he or she "ought to possess" by reason of profession, business, or calling. Hence this Section codifies the current common law standards of care required of plan administrators.

Subsection 23(3) provides that the responsibilities outlined in Subsections 23(1) and 23(2) rest with each member of the pension committee or board of trustees that may act as plan administrator, and with each member of a board, agency, or commission made responsible by an Act of the Legislature for the administration of a pension plan.

Subsection 23(4) asserts that the plan administrator shall not "knowingly permit his or her interest to conflict with his or her duties and powers." This again represents a codification of common law concerning conflict of interest. Many administrators are involved in a wide range of activities, and Subsection 23(4) has no limits on the possibilities for pointing to any such activity as the basis for a conflict of interest. It should also be noted that trade union officials serving as plan administrators may expose themselves to conflict of

interest, where their official union position may be seen as including them towards a certain decision. Special benefits for new plan members, or disregard for deferred former members could be seen as involving a conflict of interest for the union official.

Subsection 23(5) permits the administrator to delegate responsibilities to other persons. Subsection 23(6) requires that only a prescribed person may be a trustee of a pension fund. Subsection 23(7) places responsibility for the choice and supervision of every agent directly on the shoulders of the administrator. The administrator must "personally select the agent," "be satisfied of the agent's suitability to perform the act," and "carry out such supervision of the agent as is prudent and reasonable." These requirements mirror the common law of agency in rendering the administrator legally liable for the acts of his or her agent. Subsection 23(8) clarifies that the same standard of care required of administrators is also required of their agents. That is, the employee or agent of the administrator is expected to act with the "care, diligence, and skill" of a person of ordinary prudence, and to avoid acting under a conflict of interest in dealing with the administration of the plan or the investment of the pension fund.

Subsection 23(9) limits the administrator's remuneration to certain standard payments, and these fees and expenses must be in accordance with the common law or provided for in the plan. The administrator is permitted to be a member of the plan receiving benefits or a refund of contributions as a member. Subsection 23(10) extends these limitations

to a pension committee or board that acts as plan administrator. And Subsection 23(11) extends these limitations to the agents of administrators, who can charge only usual and reasonable fees and expenses for the services they provide.

To demonstrate that these standards of care have been made, certain procedures may be advisable, particularly in regard to careful documentation of the reasons for a specific decision. Since Section 23 covers all administrative and investment decisions, it may result in the more careful documentation of all decisions. Furthermore, it may be advisable to obtain legal opinions prior to decisions that could result in legal action pursuant to Section 23. Of special concern in regard to careful documentation and legal opinion are situations where a conflict of interest might be alleged. This caution extends to "agents" of the administrator, and the term "agents" can be interpreted to include pension and investment consultants. The relationships between the administrator and the agents deserve special care since the administrator remains responsible for their decisions even though the agents are also responsible. In particular, the administrator is required by Section 23 to select the agents personally and to delegate responsibility only when it is prudent to do so. Hence the administrator should document the reasons why an agent is retained and the details concerning the responsibilities to be delegated to the agent.

Section 63 empowers the Cabinet to develop regulations that shall govern the investment of pension assets. Section 63, itself, is

extremely broad. This wording of Section 63 enables the Cabinet to modify the investment regulations on its own initiative without having to obtain the legislature's approval through an amendment to the Act.

The former Pension Benefits Act provided quantitative and qualitative limitations on pension fund investments either explicitly or by reference to the Canadian and British Insurance Companies Act. While these limitations were designed to protect the plan's beneficiaries by limiting the investment risk exposure of the pension fund, it was not clear whether the objective was realized. Arguments were put forward that the limitations restricted an investment manager from investing pension funds in the best possible manner. Therefore the new investment regulations, Sections 63 to 78 inclusive, ease the restrictions by moving towards a prudent person approach to investing pension funds, with some quantitative limitations.

The Regulations are based upon what is referred to as "the prudent person approach." This concept has been discussed above in connection with Section 23 of the Act which places responsibility on the administrator of the plan. This Section 23 responsibility covers the decisions of the administrator in the investment of the fund, as well as in the administration of the plan itself. Hence Section 23 should be studied in connection with Section 63. Subsections 23(1) and 23(4) describe these requirements as follows:

Subsection 23(1):

The administrator of a pension plan shall exercise the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person.

Subsection 23(2):

The administrator of a pension plan shall use in the administration and investment of the pension fund all relevant knowledge and skill that the administrator possesses or, by reason of his or her profession, business or calling, ought to possess.

That is, the administrator's actions with respect to the pension fund must be prudent, and furthermore, if the administrator has special and relevant skills he or she is expected to use them in the course of duties as Administrator. This standard of care is basically the same that has existed in the common law for years and also in Trust Law. What is new about it is that it is now codified in the Act.

Another important point about prudence is that the standard of prudence that applies to the administrator, also applies to any agent of the administrator; and that would include the Investment Manager, the Custodian, the Consultant, or any other person involved in the administration or investment of the pension fund. However, the fact that each agent is also subject to this responsibility does not enable the administrator to avoid his or her responsibility through delegation to an agent. Subsection 23(5) requires that an administrator employ one or more agents only "where it is reasonable and prudent in the circumstances so to do." Subsection 23(7) requires that the administrator "shall personally select the agent and be satisfied of the agent's suitability

to perform the act for which the agent is employed, and the administrator shall carry out such supervision of the agent as is prudent and reasonable." In the Investment Regulations, prudence is only referred to, because the Regulations need not redefine what is already stated in the Act. Hence, Section 23 forms an essential component in understanding the Investment Regulations.

Section 63 of the Regulations requires that the administrator must "establish and adopt a written statement of investment policies and goals for the plan."

There has to be an explicit statement of investment policies to ensure that the administrator and its agents can carry on their duties with the same goals in mind. Furthermore, the administrator and its agents are required to adhere to it. For many plans this should not prove an onerous task because they may already have such a statement or have been operating under a similar set of informal guidelines.

Not only does the statement of investment policies and goals detail the precise investment mandate of the administrator and its agents, but it also provides the benchmark to measure their performance. It is for this reason that the administrator and its agents will have to ensure that a workable and practical document is drafted and that all involved can adhere to it.

The minimum contents for this investment statement are presented in Subsection 63(3) of the Regulations, and these include the following:

1. identifying the type of plan and the nature of its liabilities;
2. guidelines for investment portfolio diversification at both the aggregate and individual investment limits;
3. the categories and sub-categories of investments and loans that may be made;
4. asset mix policy and rate of return expectations;
5. a conflict of interest policy and minimum disclosure requirements and the timing of such disclosure;
6. lending policies;
7. the retention or delegation of voting rights;
8. the basis for the valuation of investments not regularly traded.

Those are the minimum requirements for the statement. Plan Administrators are encouraged to include other issues or considerations, but they are not required to do so , unless to do so would be considered "prudent". The following comments relate to the required elements.

Identifying the type of plan means simply stating whether it is a defined benefit plan, a defined contribution plan, or a combination of both, and what features were taken into account in the setting of the investment policies. As for the "nature of liabilities", it is not necessary to present precise figures, but if the fact that the fund is underfunded was taken into account when developing the investment strategy then that should be included. This requirement is really meant

for the drafters to acknowledge the aspects of the pension promise that impacted the chosen strategy.

For example, one might suppose that a defined contribution plan would have no liabilities beyond that of making the required contributions. However, some statements may acknowledge a "responsibility" on the part of the sponsor to conserve capital as well as to achieve long-term growth, and may indicate that this results in a balanced fund approach for the plan. So it is not only the contractual liabilities that should be stated here, but also any non-contractual or perceived liabilities that are acknowledged in setting the framework for the investment policy which follows.

As for "guidelines for investment portfolio diversification at both the aggregate and individual investment limits", the Commission expects statements about broad asset classes that will be used for diversification purposes, and the diversification limits within those classes, such as "no holding any exceed 5% of the fund or represent less than 1% of the fund".

Asset Mix Policy must be detailed, including establishing ranges for the major asset classes. It is not acceptable to file a statement where these ranges for asset classes are unreasonably wide. That is, those who have an interest in the pension fund must be able to obtain a clear picture in regard to the division of the fund into types of equities and fixed income assets.

Nevertheless, it is understood that the investment manager must implement the policies and, given volatile markets, must be given enough maneuvering room. Where it could be reasonably anticipated that stated guidelines might be exceeded in extraordinary conditions, that statement could include a process and procedure for the investment manager to follow to exceed the limits for a time until the pension committee could meet to discuss the action.

In regard to the "rate of return expectations" the statement should indicate the return expectations of the stated asset mix policy. This could be as simple as CPI plus a certain percentage, over the coming five years; or it could be passive portfolio benchmarks with a value-added analysis for each portfolio manager. In essence, this should indicate what return goals were taken into account when drafting the investment strategy, and what the plan intends the investments to achieve.

The "categories and subcategories of investment and loans that may be made" means that the statement must include a list of all the types of investments which the fund may invest. For an example of what the Commission considers as a "category" of investments, it is helpful to consider the audit requirements of the Commission. This list is of utmost importance given that if the statement does not specifically indicate that the plan can invest in venture capital, then it can not do so.

The conflict of interest policy will apply to both actual and perceived conflicts and must include the procedures to be followed when a conflict arises. A conflict can exist with a member of the pension committee or its chair, particularly when there are outside appointed directors, on the part of the investment manager or any agent of the Administrator. The procedure should detail how and when the conflict must be disclosed and to whom, as well as how decisions are to be made for the situation which gave rise to the conflict. For many corporations that already have a conflict of interest policy for their Board of Directors, this should not be a burdensome task; for those who do not, legal advise may be required.

The statement must also include determining who may exercise the voting rights attached to the investments and under what circumstances. The Administrator may delegate those rights to the investment manager but retain the right to exercise them in extraordinary circumstances.

The last requirement of the statement is how to value non-regularly-traded investments. The statement must indicate whether appraisals will be done on such investments, when, and by whom. If they are not periodically valued, how can their contribution to investment return be determined?

Section 64 of the Regulations requires that this statement of investment policies and goals must be reviewed and confirmed or amended, by the administrator at least once each year. This confirmation or

amendment must be filed within ninety days of the confirmation or amendment.

Section 65 of the Regulations requires that the administrator and any agent must adhere to this statement of investment policies and goals. It also exempts the employee or agent of an administrator from the conflict of interest requirements of Subsection 23(4) of the Act, if the administrator has been given complete disclosure of the person's interest and if the investment or transaction complies with the requirements of the investment statement.

Section 66 or the Regulations presents the basic diversification 10 per cent rule that was also part of the former requirements. No more than 10% of the total book value of a pension fund's assets may be invested in or loaned to any one person, corporation and so on. A further refinement is the application of this rule to affiliated corporations and related persons. Publicly traded affiliated corporations have the 10% Rule applied individually, non-publicly traded affiliated corporations have the 10% Rule applied to the aggregate holdings; this is a clear limitation in illiquid investments.

Section 67 of the Regulations places limitations on investments in real estate and resource properties. As investments these are generally much longer terms than a stock or bond holding, and more difficult to dispose of. In aggregate, the total of all investments in real estate and resource properties must not exceed 25% of the total book value of

the plan's assets. Apart from this, there are limitations on the percentage of the fund that can be invested in a single property.

The former Act placed limitations of 4% per parcel for eligible real estate and 2% per parcel for ineligible real estate. These limitations have been replaced by a limitation of 5% per parcel. The clarification that the percentages be calculated on a "before financing" basis is how the Commission had administered the old rules even though the old rules wee silent on the issue. The concern here is risk to the pension fund. For the purposes of the per parcel test, the total amount at risk, the amount of the investment prior to financing, is the most relevant amount to monitor. There is no longer a 7% basket for ineligible real estate: conceivably all real estate investments are eligible if they are prudent.

Finally, Section 67 also places a limitation of 15% of the plan's total book value on the aggregate investments in resource properties.

Section 68 of the Regulations states that pension funds are not permitted to own more than 30% of the voting shares of any one company. It is intended that pension funds not be allowed to purchase and actively manage corporations, but rather that they be limited to the role of investor, albeit a significant one. Pension fund real estate, resource property and venture capital subsidiaries are exempted from this 30% rule.

Section 69 of the Regulations deals with non-arms-length transactions. With the exception of publicly traded securities, these are expressly forbidden. This provision is both necessary, in order to prevent self-dealing, and also consistent with the statutory provisions of Section 23 of the Act concerning conflict of interest. There is however, an allowance for investment in employer-occupied real estate, providing a written conflict of interest policy is both incorporated within the statement of investment policies and goals and complied with. This exemption to the general prohibition on conflict of interest was allowed, providing it was disclosed, because the pension fund would have greater control over the asset it owned, the building, rather then just another promise to pay in the case of a loan.

Another non-arms-length transaction, employee mortgages, has been expressly permitted providing the mortgage is insured. The requirement of insurance is a restriction over the previous rules but one that was considered necessary in order to prevent the use of inflated market values and interest rate manipulation.

Section 70 of the Regulations limits the amount that can be loaned on the security of a mortgage to 75% of the market value of the real estate or interest therein. An exception to this 75% limit is permitted where the amount of the loan in excess of 75% of market value is insured by a government agency or insurance company.

Section 71 of the Regulations provides an exception to the conflict-of-interest rules of Subsection 23(4) of the Act where real estate is occupied or to be developed by an employer or administrator.

Section 72 of the Regulations requires that all pension plans must file annual financial statements. Those plans with over $1 million in assets or representing 50 or more members must submit audited financial statements. This requirement is not effective until the 30th of June, 1988, in order to avoid substantial retroactivity. Pension plans with year-ends prior to that date will not be required to file statements until 1989. Section 72 indicates in detail the required contents of this statement.

Section 73 of the Regulations permits securities lending activities, providing the statement of investment policies allows for it and that collateral is given and maintained. Section 74 prohibits borrowing except where necessary to over a short term contingency and where the borrowing is for ninety days or less. Section 75 requires that all investments and loans must be held in the name of, or for the account of, the fund. Section 76 exempts from the Investment Regulations those contracts where the pension benefits are guaranteed by an insurance company. However, these still are governed by the statutory requirement of prudence.

Section 77 prohibits a plan from pledging, mortgaging, or hypothecating the fund's assets unless otherwise permitted by the

Regulations. Section 78 permits the fund to hold bonds, debentures, or shares if this holding results from the reorganization or liquidation of a corporation in which the fund held investments which are to be exchanged for these bonds, debentures, or shares.

Subsection 43(1) of the Regulations exempts the public service and teachers' superannuation funds from Sections 26 and 33 of the Regulations. Section 26 concerns procedures to follow in the wind-up of defined benefit plans when there are insufficient assets to cover the plan's liabilities. Section 33 deals with employer contributions to the Guarantee Fund. It is important to note that the public service and teachers' superannuation funds are not exempted from the other sections of the Act and Regulations that could bear upon the proposed reorganization.

Subsection 43(3) of the Regulations also exempts the public service and Teachers' superannuation funds from the application of Subsection 4(3) of the Regulations, which prescribes certain time periods within which the employer is required to make its contributions.

In the interest of treating public and private plan members equally, consideration should be given to repealing these exemptions.

Part 4: <u>Escalated Adjustments, Plan Wind-Ups, and Surpluses</u>

Section 8 of the Regulations provides that the estimated future costs of escalated adjustments may be excluded from funding requirements.

A major reason for inserting this provision was to allow the Ontario government to avoid funding its promised inflation protection. Two points deserve comment. First, in recent years accountants and securities analysts have become increasingly concerned about unfunded pension promises. New CICA guidelines and new FASB rules require that financial statements explicitly report the liability connected with escalated adjustments. Hence, the government of Ontario may increasingly be subjected to scrutiny from securities analysts in this regard. Second, Section 8 of the Regulations could conceivably be repealed. This would require the funding of escalated adjustments.

Subsection 43(1) of the Regulations exempts the public service and teachers' superannuation funds from Sections 26 and 33 of the Regulations. Section 26 concerns procedures to follow in the wind-up of defined benefit plans when there are insufficient assets to cover the plan's liabilities. Section 33 deals with employer contributions to the Guarantee Fund. It is important to note that the public service and teachers' superannuation funds are not exempted from the other sections of the Act and Regulations that could bear upon the proposed reorganization.

Sections 69-78 deal with the wind-up of pension plans and Sections 79 and 80 deal with payment of surplus to the employer. Mr. Coward has recommended that "[c]hanges to amalgamate the PSSF and TSF with the corresponding SAFs and to reorganize the funding should be made with a minimum of delay" (Summary, p. 6). This could involve using existing

surpluses from the PSSF and TSF to pay for existing deficits in the SAFs. It may be important to consider the implications of the Act for this reorganization, quite apart from the legality of this procedure in the context of current judicial decisions and legal opinions.

Because of the recent emergence of substantial surpluses in some defined benefit plans, and the uncertainly regarding entitlements to surplus created by conflicting plan provisions and court judgements, the government has recognized the necessity to formulate a consistent policy with respect to surplus refunds. The Task Force on Inflation Protection addressed this issue in its recommendations. As of February 9, 1986, until such time as a policy is formulated and in place, the Commission is prohibited from giving its consent to any refunds of surplus to an employer from an ongoing plan. Refunds on wind-up or partial wind-up had been permitted as outlined in PBA 1987, and Regulations. However, as of February 10, 1988, even these refunds on wind-up or partial wind-up have been prohibited by Section 7(a) of the Regulations until government policy is enacted in amendments to PBA 1987.

These new provisions of PBA 1987 dealing with surplus have emphasized the requirement that the employer must have explicit entitlement to surplus assets documented in the plan in order to have access to those assets. However, this clarification of ownership of surpluses deals only with the surpluses that accumulate after 1/1/1987. For surpluses that accumulated prior to 1/1/1987, recourse to the courts may still be necessary to determine ownership, and new government legislation may also impact this issue.

Table 1

PENSION BENEFITS ACCRUED (AS A FRACTION OF WAGE) FOR MEMBER OF A REPRESENTATIVE PENSION PLAN*

	No Inflation**		High Inflation**			
			Nominal Pension Benefit		Fully Indexed Pension Benefit	
Age	Early Entrant	Late Entrant	Early Entrant	Late Entrant	Early Entrant	Late Entrant
45	0.10	0.00	0.01	0.00	0.03	0.00
46	0.10	0.00	0.02	0.00	0.03	0.00
47	0.11	0.16	0.02	0.01	0.04	0.03
48	0.12	0.09	0.02	0.01	0.05	0.02
49	0.12	0.09	0.03	0.01	0.06	0.02
50	0.13	0.10	0.03	0.01	0.07	0.03
51	0.14	0.10	0.04	0.02	0.08	0.04
52	0.15	0.11	0.04	0.02	0.09	0.05
53	0.16	0.12	0.05	0.03	0.11	0.06
54	0.17	0.13	0.06	0.03	0.13	0.07
55	0.18	0.13	0.07	0.04	0.16	0.08
56	0.19	0.14	0.09	0.05	0.19	0.10
57	0.21	0.16	0.10	0.06	0.22	0.12
58	0.22	0.17	0.12	0.07	0.26	0.15
59	0.24	0.18	0.15	0.09	0.31	0.18
60	0.26	0.20	0.17	0.10	0.37	0.22
61	0.29	0.21	0.21	0.13	0.44	0.27
62	0.31	0.23	0.25	0.15	0.53	0.32
63	0.34	0.25	0.30	0.18	0.63	0.39
64	0.38	0.28	0.35	0.22	0.76	0.48
65	0.41	0.31	0.43	0.27	0.91	0.58

* Details of the pension plans are as follows: 1) the benefit is nominal and equals 1.4% of final 3-year average earnings up to YMPE and 2% for earnings in excess of YMPE; 2) normal retirement age is 65; 3) vesting is after 2 years of service; 4) early retirement is at age 55 and 10 years of service, with actuarial reduction of accrued benefits;
5) there is no special retirement provision; 6) if member opts for postponed retirement, benefits continue to accrue but previously accrued benefits are not actuarially increased.

** The real rate of interest is 3% and the rate of growth of real wages is 2%. The rate of inflation is zero in the 'No Inflation' scenario, and 10% in the 'High Inflation' scenario. The early entrant commences employment with the sponsoring firm when he is age 30. The late entrant commences employment with the sponsoring firm when he reaches ages 45.